The Internal Revenue Service Acted on Recommendations to Help Farmers Receive the Intended Benefit of the Farm Income Averaging Provision

July 2003

Reference Number: 2003-30-142

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

July 3, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and Corporate Programs)

SUBJECT: Final Audit Report - The Internal Revenue Service Acted on Recommendations to Help Farmers Receive the Intended Benefit of the Farm Income Averaging Provision (Audit # 200330001)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) effectively informed taxpayers about retroactive changes it made to regulations regarding the "Farm Income Averaging" provision of the tax law and whether farmers filed amended tax returns to benefit from the changed regulations.

A provision in the Taxpayer Relief Act of 1997[1] allowed farmers to elect to compute their tax liabilities by averaging farm income over a 3-year period. This provision was designed to smooth out the economic disparities that farmers experience from year to year.

The IRS originally interpreted the farm income averaging provision of the tax law to exclude negative income from the calculations. However, members of the Senate issued a letter to the IRS stating that this interpretation was inconsistent with the intent of the Congress and recommending that proposed IRS regulations be amended to clarify that "taxable income" may be negative for the purpose of farm income averaging. The IRS responded by making the necessary changes to the regulations to enable farmers to use negative taxable income in their averaging computations. These

[1] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

changes were implemented for Tax Year (TY) 2000 and were made retroactive to TY 1998. However, farmers were required to file amended tax returns to claim any refund of tax for TYs 1998 or 1999.

In summary, we estimate that more than 4,200 farmers excluded negative amounts in their averaging calculations for TY 1999 because of the IRS' interpretation of the farm income averaging provision, but did not amend their returns. We estimate these farmers' tax accounts were overpaid by more than $4.4 million.

Because the preliminary results of our review indicated many farmers did not know about the opportunity to amend their tax returns for refunds, we brought this issue to the attention of the IRS before completing our review. We issued a memorandum to the IRS in February 2003, less than 2 months before the statute of limitations for amending TY 1999 returns was to expire. We recommended that the IRS explore the feasibility of issuing notices to affected taxpayers and that it explore ways to allow these taxpayers more time to amend their tax returns.

Our draft report contained information not included in our memorandum regarding the cause of the finding, as well as the benefit our recommendations would have on tax administration. Because the IRS had responded to our memorandum and had taken adequate corrective actions, we invited IRS management's comments regarding this additional information but did not require an additional response. The IRS determined that no additional comments were warranted.

Copies of this report are also being sent to the IRS managers affected by the report findings. Please contact me at (202) 622-6510 if you have questions or Richard J. Dagliolo, Director (Submission Processing), at (631) 654-6028.

Table of Contents

Background

A provision in the Taxpayer Relief Act of 1997[1] allowed farmers to elect to compute their tax liabilities by averaging farm income over a 3-year period. This provision was designed to smooth out the economic disparities that farmers experience from year to year. The Internal Revenue Service (IRS) designed Farm Income Averaging (Schedule J) for calculating tax liabilities using the averaging method.

The IRS originally interpreted the farm income averaging provision of the tax law to exclude negative income from the calculations. However, members of the Senate issued a letter to the IRS stating that this interpretation was inconsistent with the intent of the Congress and recommending that proposed IRS regulations be amended to clarify that “taxable income” may be negative for the purpose of farm income averaging. The IRS responded by making the necessary changes to the regulations to enable farmers to use negative taxable income in their averaging computations. These changes were included in the Schedule J instructions for Tax Year (TY) 2000 and were made retroactive to TY 1998. However, farmers were required to file amended tax returns to claim any refund of tax for TYs 1998 or 1999. We initiated this review because taxpayers/farmers affected by the IRS’ original interpretation of the law may not have been aware of the retroactive changes made to the tax regulations in subsequent years and may not have received refunds to which they were entitled.

We conducted our audit at the IRS’ Ogden Campus[2] and offices of the IRS’ Small Business/Self-Employed (SB/SE) Division located in New Carrollton, Maryland, and near Cincinnati, Ohio. This audit was performed in accordance with *Government Auditing Standards.* Detailed information

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[1] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).
[2] The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Farmers Who Averaged Their Incomes in Tax Year 1999 Did Not Receive the Full Intended Benefit of the Income Averaging Provision

Using computer analysis, we identified 4,398 taxpayers who most likely calculated the taxes on their TY 1999 individual income tax returns using Schedule J and had not amended their tax returns. (See Appendix IV for the selection criteria we used in our computer analysis.)

We selected a statistical sample of 70 returns for these taxpayers and found the following:

- All 70 had calculated their taxes using Schedule J.
- Sixty-eight (97 percent) of these 70 taxpayers had excluded negative amounts in their averaging calculations.
- These 68 taxpayers had overpaid their taxes by an average of $1,039.[3]

It is likely that taxpayers were not aware that the IRS had made retroactive changes to the farm income averaging provision. The IRS did not perform education or outreach activities to disseminate this information to farmers or their tax preparers. On the other hand, the IRS did publish information regarding the retroactive changes in the TYs 2000, 2001, and 2002 instructions for Schedule J, as well as in *Farmer's Tax Guide* (Publication 225) and *Highlights of 2000 Tax Changes* (Publication 553).

However, the IRS did not include information about the change in the instructions for Profit or Loss From Farming (Schedule F), which in our view would have been the single most effective place to publish the information. Every farmer (or his or her tax preparer) would likely refer to Schedule F every year. Farmers might not file or even refer to Schedule J in TY 2000 if they had just averaged their income in TY 1999. The same is true of information

[3] All 68 of the taxpayers had calculated income tax amounts higher than they should have been. However, 18 of these taxpayers were liable for the alternative minimum tax. Even when the farm income averaging provision was properly applied, the tax benefit of the provision was eliminated by the alternative minimum tax.

included in Publication 225. This publication, over 100 pages long, would be less likely to be referred to if farmers had just averaged their income in the prior year.

Based on the results of our sample, we estimate that more than 4,200 farmers excluded negative amounts in their averaging calculations for TY 1999 because of the IRS' interpretation of the farm income averaging provision. We estimate these farmers' tax accounts were overpaid by more than $4.4 million.[4]

Because the preliminary results of our review indicated many farmers did not know about the opportunity to amend their tax returns for refunds, we brought this issue to the attention of the IRS before completing our review. We issued a memorandum to the IRS in February 2003, less than 2 months before the statute of limitations for amending TY 1999 returns was to expire (see Appendix V). We recommended that the IRS explore the feasibility of issuing notices to affected taxpayers and that it explore ways to allow these taxpayers more time to amend their tax returns.

In response, the SB/SE Division's Customer Account Services, Accounts Management function took extraordinary steps to send notices to the affected taxpayers, informing them about the issue and how to file amended returns before the statute of limitations expired. The IRS also provided taxpayers with a method to obtain more time to file the amended returns for TY 1999, but advised us that it had no authority to revive a statute that had expired, so it could take no corrective action for TY 1998 returns. In addition, employees from the SB/SE Division's Taxpayer Education and Communication function disseminated information regarding this issue to tax preparer groups and farmer groups. (See Management's Response to Memorandum #1 in Appendix VI.)

[4] It is highly likely that a similar number of taxpayers filing Schedule J in TY 1998 were negatively affected by the IRS' interpretation of the farm income averaging provision, but the statute of limitations for filing claims for refunds had already expired for TY 1998 returns.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) effectively informed taxpayers about retroactive changes it made to regulations regarding the "Farm Income Averaging" provision of the tax law and whether farmers filed amended tax returns to benefit from the changed regulations.

To accomplish our objective, we:

I. Identified all taxpayers that had positive income from farming during Tax Year (TY) 1999 as well as negative taxable income in any of the 3 prior years.

   A. Wrote a computer program to identify tax returns on the IRS' Individual Master File[1] that met the criteria above.

   B. Randomly selected 20 returns identified by our computer program to verify whether they met the criteria requested.

      1. Researched these returns on the IRS' Integrated Data Retrieval System (IDRS)[2] to confirm whether the data in the database were accurate.

      2. Confirmed whether the taxpayers in the database had not filed an amended return to recover taxes paid for TY 1999.

   C. Analyzed the entire database to identify taxpayers that had farm income in TY 1999 of $500 or more, taxable income in TY 1999 of $500 or more, an amount present in the field "Tentative tax – ERS verified," 3 taxable income losses in any of the prior 3 tax years (1998, 1997, 1996), and no amended return for TY 1999. This analysis resulted in the identification of a total of 4,398 taxpayers.

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[1] The IRS database that maintains transactions or records of individual tax accounts.

[2] An IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

[3] IRS computers calculate tax liabilities based on information contained on tax returns submitted by taxpayers and entered onto the computers by IRS employees. Any differences between the tax calculated by the taxpayer and the tax calculated by the computer must be resolved by IRS employees. Because information from Farm Income Averaging (Schedule J) was not entered into IRS computers for TY 1999, the amount of tax calculated by the taxpayer and the amount of tax calculated by the computer would be different for any tax return containing a Schedule J. To resolve the difference, an IRS employee in the Error Resolution function (ERS) would scan the tax return to see if a Schedule J was present, and if it was, the employee would accept the taxpayer's calculation. When this was done, information was entered into a field called "Tentative tax – ERS verified."

D. Reviewed a statistical sample of 70 of the 4,398 returns identified above (95 percent confidence level, precision level of +\- 4 percent, expected error rate of 3 percent) to determine whether the taxpayers used the Schedule J, whether the taxpayers excluded negative taxable income in their tax calculations, and what effect this had on their tax liabilities. Recalculated the tax liabilities for TY 1999 with the revised Schedule J instructions allowing them to use negative income in averaging the farm income. Requested that IRS employees with experience working the Schedule J review the first 17 cases we had completed to ensure our calculations were accurate.

E. Developed the overall effect for the remainder of the database from the results of step I.D. by calculating the average change in tax and applying this to the number of taxpayers in the database identified as excluding negative income from their original income averaging calculations.

II. Identified the IRS' efforts to notify taxpayers of the change to the averaging calculation.

A. Reviewed News Releases and Bulletins to determine what effort was made to contact taxpayers that should file amended returns.

B. Reviewed the efforts to contact taxpayers concerning the need to file an amended return and determined if these efforts were sufficient.

C. Interviewed IRS officials to determine the efforts that were made to inform taxpayers of the averaging change.

Appendix II

Major Contributors to This Report

Richard J. Dagliolo, Director
Kyle R. Andersen, Acting Director
Bill R. Russell, Acting Audit Manager
L. Jeff Anderson, Senior Auditor
W. George Burleigh, Senior Auditor
Roy E. Thompson, Senior Auditor
James E. Adkisson, Computer Specialist

Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner for Services and Enforcement N:DC
Acting Deputy Commissioner, Small Business/Self-Employed Division S
Director, Customer Account Services, Small Business/Self-Employed Division S:CAS
Director, Taxpayer Education and Communication, Small Business/Self-Employed Division S:T
Director, Accounts Management, Small Business/Self-Employed Division S:CAS:AM
Deputy Director, Accounts Management, Small Business/Self-Employed Division S:CAS:AM
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division S

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; $4,432,374 in overpaid tax from 4,266 taxpayer accounts (see page 2).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to develop a database containing 4,398 Tax Year (TY) 1999 individual income tax returns meeting the following criteria:

- Income of $500 or more from farming in TY 1999.
- Taxable income of $500 or more in TY 1999.
- Amount present in "Tentative tax – ERS verified"[1] for TY 1999.
- Negative taxable income in any of the prior 3 tax years.
- No amended return for TY 1999.

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[1] Internal Revenue Service (IRS) computers calculate tax liabilities based on information contained on tax returns submitted by taxpayers and entered onto the computers by IRS employees. Any differences between the tax calculated by the taxpayer and the tax calculated by the computer must be resolved by IRS employees. Because information from Farm Income Averaging (Schedule J) was not entered into IRS computers for TY 1999, the amount of tax calculated by the taxpayer and the amount of tax calculated by the computer would be different for any tax return containing a Schedule J. To resolve the difference, an IRS employee in the Error Resolution function (ERS) would scan the tax return to see if a Schedule J was present, and if it was, the employee would accept the taxpayer's calculation. When this was done, information was entered into a field called "Tentative tax – ERS verified."

We reviewed a statistical sample of 70 of these 4,398 returns (95 percent confidence level, precision level of +\- 4 percent, expected error rate of 3 percent) and found that all 70 had calculated their tax using a Schedule J. Sixty-eight (97 percent) of these 70 taxpayers had excluded negative amounts in their averaging calculations. The average overpayment for these 68 cases was $1,039.[2] Based on these results, we estimate that 4,266 taxpayer accounts (4,398 x .97) contained overpaid income taxes totaling $4,432,374 (4,266 accounts x $1,039).

[2] All 68 of the taxpayers had calculated income tax amounts higher than they should have been. However, 18 of these taxpayers were liable for the alternative minimum tax. Even when the farm income averaging provision was properly applied, the tax benefit of the provision was eliminated by the alternative minimum tax.

Appendix V

Memorandum #1: Farmers Who Averaged Their Income Did Not Receive the Full Intended Benefit Because of the Internal Revenue Service's Interpretation of the Farm Income Averaging Provision

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL for TAX ADMINISTRATION

February 21, 2003

Response Date:
March 10, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)

SUBJECT: Farmers Who Averaged Their Income Did Not Receive the Full Intended Benefit Because of the Internal Revenue Service's Interpretation of the Farm Income Averaging Provision

The purpose of this memorandum is to advise you of the interim results of our review to determine whether taxpayers that qualified for farm income averaging received the full intended benefit of the averaging provision. Our initial results indicate that many taxpayers with farm income in Tax Year (TY) 1999 who incurred losses in at least one of the three preceding years did not receive the full intended benefit of the averaging provision because the Internal Revenue Service (IRS) did not allow taxpayers to include negative taxable income in their averaging calculation. At the request of the Senate, the IRS subsequently changed the rules and began allowing negative taxable income in the averaging calculation. The IRS made the changes retroactive, but many taxpayers have not amended their returns to take advantage of the changes.

We are informing you of this before the completion of our review because the statute of limitations for taxpayers to amend their timely filed TY 1999 individual income tax returns expires April 15, 2003. Therefore, it is extremely important that the IRS determine what actions can be taken to facilitate affected taxpayers amending their returns and begin to immediately take those actions. Please provide your written response to the facts presented in this memorandum along with any corrective actions you propose to take within 15 days of the date of this memorandum.

Background

A provision in the Taxpayer Relief Act of 1997[1] allowed farmers to elect to compute their tax liability by averaging farm income over a 3-year period. This provision was designed to smooth out the economic disparities that farmers experience from year to year. The IRS designed *Farm Income Averaging* (Schedule J) for calculating tax liabilities using the averaging method.

Although the IRS originally interpreted the law to exclude negative income in the calculations, members of the Senate issued a letter to the IRS stating that the IRS' interpretation of the farm income averaging provision of the tax law was inconsistent with the intent of Congress and recommended that proposed IRS regulations be amended to clarify that "taxable income" may be negative for the purpose of farm income averaging. The IRS responded by making the necessary changes to the regulations to enable farmers to use negative taxable income in their averaging computations. These changes were included in the Schedule J instructions for TY 2000 and were made retroactive to TY 1998. However, farmers were required to file amended tax returns to claim any refund of tax for TY 1998 or 1999. We initiated this review because taxpayers/farmers affected by the IRS' original interpretation of the law may not be aware of the retroactive changes made to the tax regulations in subsequent years, and may not receive refunds to which they are entitled.

Results

Using computer programs, we identified 4,398 taxpayers who most likely calculated the tax on their 1999 individual income tax return using Schedule J, and had not amended that tax return. (See the attachment to this memorandum for the selection criteria we used in our computer program.) We selected a statistical sample of 70 of these taxpayers and have ordered their tax returns for TY 1999 and the 3 prior years. To date, we have received tax returns for 19 of these 70 taxpayers. We reviewed the returns for these 19 taxpayers to determine whether they filed a Schedule J in TY 1999 and whether the IRS' original interpretation of the law resulted in the taxpayers paying more tax than necessary. All 19 taxpayers calculated their tax in TY 1999 using Schedule J. All 19 excluded negative amounts in their averaging calculation that resulted in them overpaying their tax. We recalculated the tax for these 19 taxpayers and found that on average, the taxpayers had overstated their tax by $633.

We have not yet reviewed enough cases to form statistically valid projections of the number of taxpayers affected or the overall tax effect. However, based on our results

[1] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

to date, we estimate that these 4,398 taxpayers may have overpaid more than $2.78 million in tax in TY 1999. These taxpayers most likely were not aware that the IRS had made retroactive changes to the farm income averaging provisions, and that they could file amended returns for refunds resulting from those changes. It is highly likely that similar numbers of taxpayers filing Schedule J in TY 1998 were negatively affected by the IRS' interpretation of the farm income averaging provision but the statute of limitations for filing claims for refunds has already expired for TY 1998 returns.

To facilitate immediate corrective action by the IRS, TIGTA will make our database available the Small Business/Self Employed Division Directors of Customer Account Services and Taxpayer Education and Communication. Again, because of the time sensitivity of this issue with regard to TY 1999 returns, we are bringing this matter to your attention before we have completed our review.

Recommendations: The Director, Customer Accounts Services, and the Director, Taxpayer Education and Communication, Small Business/Self-Employed Division, should immediately take the following actions:

- Explore the feasibility of issuing notices to the taxpayers who overpaid their taxes because the IRS did not allow them to include negative taxable income when calculating their tax under the farm income averaging provision. TIGTA's computer database is available to assist the IRS in this action. The notice should inform the taxpayers of the retroactive changes made to the farm income averaging provision, and invite them to amend their TY 1999 individual income tax return if the changes to the provision affected them.
- Explore ways to allow these farmers more time to file for refunds or credits on TY 1998 and TY 1999 income tax returns if they calculated their taxes using Schedule J but did not include negative taxable income in the calculation.

Please contact me at (215) 516-2341 if you have questions or Richard Dagliolo, Director, at (631) 654-6028.

Attachment

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Attachment

Criteria to Identify Taxpayers Calculating Their Income Taxes Using *Farm Income Averaging* (Schedule J) in Tax Year 1999 But Not Receiving the Intended Benefit of the Averaging Provision

Information from Schedule J was not entered into Internal Revenue Service (IRS) computers for Tax Year (TY) 1999 so it was not possible for us to isolate, with 100 percent accuracy, only those taxpayers filing Schedule J. However, we developed criteria that could identify, with reasonable assurance, those taxpayers filing Schedule J.

IRS computers calculate tax liabilities based on information contained on tax returns submitted by taxpayers and entered onto the computers by IRS employees. Any differences between the tax calculated by the taxpayer and the tax calculated by the computer must be resolved by IRS employees. Because information from Schedule J was not entered into IRS computers for TY 1999, the amount of tax calculated by the taxpayer and the amount of tax calculated by the computer would be different for any tax return containing a Schedule J. To resolve the difference, an IRS employee in the Error Resolution function (ERS) would scan the tax return to see if a Schedule J was present, and if it was, the employee would accept the taxpayer's calculation. When this was done, data was entered into a field called "tentative tax - ERS verified."

The amount of tax calculated by the taxpayer, the amount of tax calculated by the computer, and the ERS verified amount are all retained in IRS computer records. So to isolate those taxpayers who most likely filed a Schedule J but did not receive the full intended benefit of the averaging provision, we selected those taxpayers accounts meeting the following criteria:

- Income from farming in TY 1999 of $500 or more.
- Taxable income in TY 1999 of $500 or more.
- Amount present in "Tentative tax – ERS verified" for TY 1999.
- Negative taxable income in 1 of the prior 3 years.
- No amended return for TY 1999.

Appendix VI

Management's Response to Memorandum #1

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

MAR 26 2003

RECEIVED
MAR 27 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Joseph Kehoe
Commissioner, Small Business/Self Employed Division

SUBJECT: Response to TIGTA Audit 200330001 Interim Memorandum - Farmers Who Did Not Receive the Full Intended Benefit Because of the Internal Revenue Service's Interpretation of the Farm Income Averaging Provision

I have reviewed your memorandum dated February 21, 2003, which provided information on taxpayers that qualified for farm income averaging but may not have received the full benefit. The Taxpayer Relief Act of 1997 enabled farmers to average their income over a three-year period. The IRS originally interpreted the legislation to exclude negative taxable income when computing average taxable income. In 2000, the IRS changed its interpretation and began allowing negative taxable income to be used. This change was made retroactive to 1998 and subsequent years. Your memorandum recommended that the IRS:

- Explore the feasibility of issuing notices to the taxpayers who overpaid their taxes because we did not allow them to include negative taxable income when they calculated their tax under the farm income averaging provision. The notice should inform the taxpayers of the retroactive changes made to the farm income averaging provision, and invite them to amend their 1999 individual income tax return if the changes to the provision affected them.

- Explore ways to allow these farmers more time to file for refunds or credits on TY 1998 and TY 1999 income tax returns if they calculated their taxes using Schedule J but excluded negative taxable income in the calculation.

Prior to receiving your recommendations, the IRS had taken actions to inform affected taxpayers of the retroactive changes. The IRS provided information in the tax year 2000, 2001, and 2002 instructions for Schedule J, Farm Income Averaging, that told taxpayers of the change and how to file Form 1040X, Amended U.S. Individual Income Tax Return, to receive the additional benefit. Information was also provided in Publication 225, Farmer's Tax Guide and Publication 553, Highlights of 2000 Tax Changes. Although the IRS has already provided information to taxpayers, we will take actions to implement, if possible, both of TIGTA's recommendations. After receiving your recommendations, Small Business and Self-Employed (SB/SE) Division Taxpayer

Education and Communication (TEC) outreach employees also communicated with practitioner groups and farmers groups in an effort to disseminate the information.

Recommendation 1

Explore the feasibility of issuing notices to the taxpayers who overpaid their taxes because the IRS did not allow them to include negative taxable income when calculating their tax under the farm income averaging provision. TIGTA's computer database is available to assist IRS in this action. The notice should inform the taxpayers of the retroactive changes made to the farm income averaging provision, and invite them to amend their TY 1999 individual income tax return if the changes to the provision affected them.

Assessment of Cause

Because we interpreted the legislation as excluding negative taxable income when computing average taxable income, taxpayers did not receive the full benefit of the legislation on their 1998 and 1999 income tax returns.

Corrective Action

We used TIGTA's extract to identify affected taxpayers, and we created a letter to specifically address these taxpayers. The letter described the problem and provided detailed instructions on recomputing Schedule J, Farm Income Averaging, and filing Form 1040X, Amended Return. All necessary forms and instructions were provided with the letter. The letter included a toll-free phone number specifically established to answer these taxpayers' questions. It also provided an address in Philadelphia where taxpayers should send all Forms 1040X. Due to the imminent expiration of the refund statute (April 15, 2003 for the vast majority of these taxpayers), it was critical to issue the letter as soon as possible. The letter was expedited and was mailed out on March 10, 2003. The mailout was centralized at our Ogden, Utah campus. A small group of IRS employees, familiar with the process, will process all these claims.

Implementation Date

The mailout was completed March 10, 2003. On March 10, 2003, the toll-free number became available and employees began processing the Forms 1040X.

Responsible Official

Deputy Director, SB/SE CAS, Accounts Management

Corrective Action Monitoring Plan

Philadelphia Campus will track the number of claims received and the dollar amounts of the tax reductions.

Recommendation 2

Explore ways to allow these farmers more time to file for refunds or credits on TY 1998 and TY 1999 income tax returns if they calculated their taxes using Schedule J but did not include negative taxable income in the calculation.

Assessment of Cause

The statute for filing a claim for refund is three years from the date an original return was filed, or two years from the date the tax was paid, whichever is later. Therefore, if a 1998 Form 1040 was filed and paid timely, the statute for tax year 1998 returns expired April 15, 2002. For tax year 1999 returns, the statute expires April 15, 2003.

Corrective Action

Unfortunately, we do not have the authority to revive a statute, which has expired. Therefore, we could take no corrective action for tax year 1998 returns.

For tax year 1999 returns, we enclosed Form 872, Consent to Extend the Time to Assess Tax, with each letter the Ogden campus mailed. This form was not designed to extend the refund statute date. However, due to these unique taxpayers' situation, we included a statement about the 1999 farm income averaging provision on the Forms 872 we sent to them. The statement and letter stress that:

- Signing and returning the Form 872 by April 15, 2003, will extend the time for filing an amended return until April 15, 2004
- The taxpayer cannot use Form 872 for any other purpose, and
- The IRS does NOT intend to assess any additional tax for tax year 1999.

The taxpayers do not need to file Form 872 unless they intend to file an amended return but cannot do so by April 15, 2003. We sent these Forms 872 to the same address as the Forms 1040X and provided a fax number so that taxpayers can quickly return this form.

Implementation Date

The Forms 872 are included with the mailout that was completed March 10, 2003.

Responsible Official

Deputy Director, SB/SE CAS, Accounts Management

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Corrective Action Monitoring Plan

The Philadelphia Campus will keep all Forms 872 received.

If you have any questions, please contact Ellen Bell, Acting Deputy Director, SB/SE CAS, Accounts Management at (202) 283-0091.